

Part I

Section 860E -- Treatment of Income in Excess of Daily Accruals on Residual Interests

26 CFR 1.860E-2: Tax on transfers of residual interests to certain organizations
(Also §§ 511, 664, 702; 1.664-1, 1.702-1, 1.860E-1)

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ISSUES

If a charitable remainder annuity trust or a charitable remainder unitrust, as defined in section 664(d) of the Internal Revenue Code (collectively, charitable remainder trusts), is a partner in a partnership or a shareholder in a real estate investment trust (REIT), and if the partnership or the REIT has excess inclusion income from holding a residual interest in a real estate mortgage investment conduit (REMIC)—

(1) Does the charitable remainder trust have unrelated business taxable income (UBTI) as defined in section 512, causing the charitable remainder trust to lose its exemption from tax under section 664(c) for the taxable year?

(2) Is the charitable remainder trust a disqualified organization as defined in section 860E(e)(5)?

(3) Is the partnership (or REIT) subject to the pass-thru entity tax under section 860E(e)(6)?

FACTS

In the following situations, Trust TR1 and Trust TR2 meet all the requirements for exemption from tax under section 664(c) for the taxable year, except for the possible treatment of excess inclusion income as UBTI under section 860E(b).

Situation 1

Trust TR1, a charitable remainder trust, holds a ten percent partnership interest in Partnership PRS. Because PRS holds a residual interest in a REMIC, section 860C(a) requires PRS to take into account its daily portion of the REMIC's net income or net loss. For 2004, a portion of the REMIC net income taken into account by PRS was an excess inclusion, as defined in section 860E(c).

Situation 2

Trust TR2, a charitable remainder trust, holds a ten percent equity interest in Corporation R, which has elected, and is qualified, to be treated as a REIT under subchapter M of the Code. Because R holds a residual interest in a REMIC, section 860C(a) requires R to take into account its daily portion of the REMIC's net income or net loss. For 2004, a portion of the REMIC net income taken into account by R was an excess inclusion, as defined in section 860E(c). R's real estate investment trust taxable income (within the meaning of section 857(b)(2), excluding any net capital gain) was zero.

LAW

In general, section 702 requires each partner to take into account separately its distributive share of partnership items. Section 702(a)(7) requires a partner to take into account separately its distributive share of a partnership's "other items of income, gain, loss, deduction, or credit, to the extent provided in regulations prescribed by the Secretary." Section 1.702-1(a)(8)(ii) provides:

Each partner must also take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately.

Section 702(b) provides:

The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of [section 702(a)] shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Section 860E(d) requires REITs, regulated investment companies, common trust funds, and subchapter T cooperatives, to allocate excess inclusion income to the shareholders, participants, and patrons. Section 860E(d) provides:

If a residual interest in a REMIC is held by a [REIT], under regulations prescribed by the Secretary—

(1) any excess of—

(A) the aggregate excess inclusions determined with respect to such interests, over

(B) the real estate investment trust taxable income (within the meaning of section 857(b)(2), excluding any net capital gain),

shall be allocated among the shareholders of such trust in proportion to the dividends received by such shareholders from such trust, and

(2) any such amount allocated to a shareholder under paragraph (1) shall be treated as an excess inclusion with respect to a residual interest held by such shareholder.

Rules similar to the rules of the preceding sentence shall apply also in the case of regulated investment companies, common trust funds, and organizations to which part I of subchapter T [(sections 1381–1383)] applies.

Section 664(c) provides that a charitable remainder trust “shall, for any taxable year, not be subject to any tax imposed by [subtitle A], unless such trust, for such year, has [UBTI] (within the meaning of section 512, determined as if part III of subchapter F [(unrelated business income tax (UBIT) provisions under sections 511–515)] applied to such trust).”

Section 1.664-1(c) provides:

If a charitable remainder trust has any [UBTI] (within the meaning of section 512 and the regulations thereunder, determined as if part III, subchapter F, chapter 1, subtitle A of the Code applied to such trust) for any taxable year, the trust is subject to all of the taxes imposed by subtitle A of the Code for such taxable year. . . . The taxes imposed by subtitle A of the Code upon a nonexempt charitable remainder trust shall be computed under the rules prescribed by subparts A and C, part 1, subchapter J, chapter 1, subtitle A of the Code [(sections 641–646 and 661–664)] for trusts which may accumulate income or which distribute corpus.

Section 860E(b) provides, “If the holder of any residual interest in a REMIC is an organization subject to the tax imposed by section 511, the excess inclusion of such holder for any taxable year shall be treated as [UBTI] of such holder for purposes of section 511.”

Section 860E(e)(6)(A) imposes a tax on certain REITs, partnerships and other pass-thru entities (as defined under section 860E(e)(6)(B)). Section 860E(e)(6)(A) provides, “If, at any time during any taxable year of a pass-thru entity, a disqualified organization is the record holder of an interest in such entity, there is hereby imposed on such entity for such taxable year a tax equal to the product of--(i) the amount of excess inclusions for such taxable year allocable to

the interest held by such disqualified organization, multiplied by (ii) the highest rate of tax specified in section 11(b)(1).” For purposes of section 860E(e)(6), section 860E(e)(6)(B) defines the term “pass-thru entity” to include any REIT and any partnership. Section 860E(e)(5)(B) defines the term “disqualified organization” to include “any organization (other than a cooperative described in section 521) which is exempt from tax imposed by [chapter 1] unless such organization is subject to the tax imposed by section 511.”

Section 1.860E-2(b) of the Income Tax Regulations contains rules relating to the application of the pass-thru entity tax under section 860E(e)(6)(A). Among other things, § 1.860E-2(b)(4) provides, “Dividends paid by a RIC or by a REIT are not preferential dividends within the meaning of section 562(c) solely because the tax expense incurred by the RIC or REIT under section 860E(e)(6) is allocated solely to the shares held by disqualified organizations.”

ANALYSIS

1. Effect of allocation of excess inclusion income to a charitable remainder trust on its eligibility for exemption from tax under section 664(c) for the taxable year.

As a partner of PRS, TR1 has a distributive share of the excess inclusion income of PRS, as determined under section 702(a) and (b). If section 860E(b) characterizes the excess inclusion income allocated to TR1 as UBTI, TR1 will lose its exemption under section 664(c) for 2004. Section 860E(b) treats excess inclusion income as UBTI to the holder of a REMIC residual interest but only if the holder “is an organization subject to the tax imposed by section 511” (that is, subject to the UBIT). In the case of a charitable remainder trust, section 664(c) employs the definitional rules of section 512 and the other UBIT provisions to determine whether any of the trust’s income is UBTI, but it does not subject the trust to section 511. (See the discussion below under Issue 2.)

Whether section 860E(b) characterizes the excess inclusion income of charitable remainder trusts as UBTI should be determined in light of the intent underlying section 860E and other REMIC provisions. A number of the REMIC provisions are comprehensive and complementary by design. If a tax-exempt entity holds the REMIC residual interest, the REMIC provisions ensure the taxation of excess inclusion income in all events, whether or not the tax-exempt holder of the REMIC residual interest is a disqualified organization. A disqualified organization (as defined in section 860E(e)(5)(B)) is a tax-exempt entity that is not subject to UBIT. Thus, a disqualified organization cannot be subject to a tax on any excess inclusion income allocable to it. But other tax exempt entities are generally subject to UBIT and could be subject to a tax on excess inclusion income, subject to other requirements.

With respect to disqualified organizations, a REMIC is required to have in place “reasonable arrangements designed to ensure that . . . residual interests in [the REMIC] are not [transferred to] disqualified organizations” Section

860D(a)(6). If an entity nonetheless transfers a REMIC residual interest to a disqualified organization, section 860E(e)(1) imposes a tax on the transferor. Further, if a pass-thru entity has a record equity owner that is a disqualified organization, the pass-thru entity must pay a tax on the amount of excess inclusion income that is allocable to the disqualified organization. Section 860E(e)(6)(A). With respect to other tax-exempt entities (which are not disqualified organizations), section 860E(b) generally provides that, if a tax-exempt entity that is subject to the UBIT holds a REMIC residual interest, the excess inclusion income of that holder is UBTI.

Sections 860E(e)(6)(A) and 860E(b) are complementary provisions that should be interpreted consistently. If a pass-thru entity (whose equity owners may be disqualified organizations or other tax-exempt entities) holds REMIC residual interests, the two sections ensure that the excess inclusion income is taxable either to the pass-thru entity (under section 860E(e)(6)(A)) or to its tax-exempt equity owner that is subject to UBIT (under section 860E(b)). Characterizing as UBTI only the excess inclusion income that is allocable to tax exempt entities that are actually subject to the UBIT causes the two sections to operate consistently.

As discussed below, a charitable remainder trust can never be subject to the UBIT. Accordingly, TR1's distributive share of PRS's excess inclusion income is not UBTI under section 860E(b).

2. Status of a charitable remainder trust as a disqualified organization.

TR1 and TR2 are charitable remainder trusts. Under section 664(c), a charitable remainder trust is exempt from tax under subtitle A of the Code, including chapter 1, unless it has UBTI for the taxable year (determined as if UBIT applied to the charitable remainder trust). But if a charitable remainder trust has UBTI, it loses its section 664(c) tax exemption for the taxable year, and the resulting tax liability is determined under the trust tax provisions of the Code. See § 1.664-1(c). Thus, if a charitable remainder trust has UBTI, that trust becomes an organization subject to the tax imposed by sections 1 and 641 but not to the UBIT. Because a charitable remainder trust can never be subject to the UBIT, it is a disqualified organization, as defined in section 860E(e)(5). As charitable remainder trusts, TR1 and TR2 are disqualified organizations.

3. Application of the pass-thru entity tax under section 860E(e)(6)(A).

PRS and R are pass-thru entities, as defined in section 860E(e)(6)(B). For purposes of section 860E(e)(6)(A), PRS is treated as having allocated excess inclusion income to TR1, a disqualified organization, equal to its distributive share of the excess inclusion income of PRS determined under section 702. Because R's real estate investment trust income is zero, all of R's excess inclusion income is allocable to its shareholders. R's excess inclusion income is allocable to TR2, also a disqualified organization, in proportion to the

dividends paid to TR2 (determined without regard to any special allocation to TR2 of the expense for the tax under section 860E(e)(6)). See § 1.860E-2(b)(4) (providing an exception to the preference dividend rule in section 562(c)).

PRS and R have record equity owners that are disqualified organizations, to which excess inclusion income is allocable. Thus, PRS and R are subject to a tax under section 860E(e)(6)(A) on the amount of the excess inclusion income allocable to TR1 and TR2, respectively, at the highest rate specified in section 11(b)(1).

HOLDINGS

(1) Excess inclusion income allocated to a charitable remainder trust is not UBTI to the charitable remainder trust and thus does not affect the charitable remainder trust's exemption from tax under section 664(c) for the taxable year.

(2) A charitable remainder trust is a disqualified organization for purposes of section 860E.

(3) A pass-thru entity that has excess inclusion income allocable to a charitable remainder trust is subject to the pass-thru entity tax under section 860E(e)(6)(A).

DRAFTING INFORMATION

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